CPI inflation shoots up, Industrial activity recovers; RBI to keep rates on hold for now

Headline CPI inflation surprised negatively and shot up sharply to 6.9% in July 2020, marking the fourth consecutive month of a 6%+ print**—the upper bound of the RBI's target range. This was much higher than the** Consensus estimate of 6.2% (Source: Refinitiv Datastream), led by a broad-based rise, most notably in food articles (vegetables, meat & fish, pulses), pan, tobacco & intoxicants, fuel & light, transportation & communication and personal care & effects. Core inflation rose to a 21-month high of 5.8%. While higher fuel and commodity prices (bullion and other metals prices) continued to impart cost pressures despite weak demand impulses, persistence of supply-side disruptions amid localised lockdowns pushed food prices higher.

Industrial production (IIP) contracted by a lower-than-expected 16.7% YoY in June 2020 (Consensus estimate: -20%)—a meaningful improvement from a 45% YoY drop during Apr-May 2020. This was in-line with the improvement seen in other high-frequency indicators such as Manufacturing PMI, car sales, e-way bills amongst others in the month of June. The improvement was largely led by manufacturing, particularly in essential categories *viz.*, pharmaceuticals, chemicals, food products and minerals. Contraction in capital goods and consumer non-durables remained significant in June, reflecting a sustained weakness in investment and consumption demand despite easing of lockdown restrictions. In 1Q FY21, the IIP fell by 36% YoY.

The economic recovery going forward is expected to be gradual amid a continued surge in COVID-19 cases and consequent localised lockdowns implemented by states. This is reflected in several high-frequency indicators such as Google mobility, auto sales, PMI, etc., which plateaued in July after picking up in June, signalling an incommensurate impact of exit policies in reviving sentiments. Inflationary pressures on the other hand are expected to remain high in the near-term on the back of persistence of supply chain disruptions, notwithstanding expectations of a good *kharif* harvest and weak aggregate demand, but should ease in the latter part of the fiscal, supported by a favourable base. This is likely to keep the RBI on hold in the next policy, even as we see room for another 25-50bps cut in the current easing cycle, contingent on a durable reduction in inflation trajectory.

- Retail inflation accelerates sharply…: Retail inflation (CPI) witnessed a sharper-than-anticipated spike in July, rising from 6.1% in June to 6.9% in July—much higher than the Consensus estimate of 6.2% (Source: Refinitiv Datastream). This marks the fourth consecutive month of headline inflation remaining north of the upper bound of the RBI's target range (4% +/- 2%). Headline inflation in this fiscal thus far (Apr-Jul'20) has averaged at 6.7% vs. 3.1% in the same period last year.

Retail inflation accelerated sharply in July and remained above the upper bound of the RBI's target for the fourth month in a row, primarily led by supply-side disruptions and higher commodity prices.

- …Owing to supply side disruptions and higher commodity prices: The increase was largely broad-based, most notably in food articles, pan, tobacco & intoxicants, fuel & light, transportation & communication and personal care & effects. Persistence of supply-side disruptions owing to localised lockdowns implemented by states in the wake of rising COVID-19 cases has led to a surge in food prices, particularly vegetables, spices, meat & fish, pulses and oils & fats, further impacted by an unfavourable base. While inflation in pan, tobacco & intoxicants rose to 12.3%—the highest in more than 8 years, fuel & light inflation pickup up, reflecting the impact of higher crude oil prices. Transportation and communication inflation rose to 10% in July—the highest in the series—owing to higher fuel prices due to hike in fuel taxes. A sharp increase in gold/prices this year due to rising uncertainty led to personal care and effects inflation rising to an eight-year high of 13.6%. Other hard commodities have also rebounded meaningfully, prices of most of which are now back to pre-COVID-19 levels, thereby further imparting cost pressures.

- Core inflation inches up further: Core inflation (ex-food & beverages and fuel & light) inched up for the fourth month in a row to 5.8% in July 2020—the highest in 21 months. This was primarily led by on account of a sharp rise in personal care & effects inflation (on higher bullion prices), continued surge in transportation and

Core inflation inched up for the fourth month in a row led by higher bullion and other commodity prices, and hike in fuel taxes.

and communication inflation due higher petrol and diesel prices, and a modest pickup in inflation in household goods & services and education. Inflation in recreation & amusement, however, remained benign amid continued restrictions and social distancing norms. Core inflation in this fiscal year thus far (Apr-July 2020) has averaged at 5.3% vs. 4.3% in the same period last year.

- Industrial production recovers...: Industrial production contracted by a lower-than-expected 16.7% YoY in June 2020 (Consensus est.: -20%)—a meaningful improvement from a 45% YoY drop during Apr-May 2020. This was in-line with the improvement seen in other high-frequency indicators such as Manufacturing PMI, car sales, e-way bills amongst others in the month of June. This translates into a contraction of 36% YoY in Q1 FY21—one of the steepest in the world, reflecting the stringent and prolonged lockdown restrictions implemented in India.

Industrial production declined by 17% YoY in June—a meaningful improvement from a 45% YoY drop during Apr-May 2020.

- **...**Largely led by essential manufacturing sectors: The improvement in IIP in June was largely led by manufacturing sector, down -17.1% YoY vs. -52% YoY drop during Apr-May 2020, as lock-down restrictions were eased. That said, the improvement was primarily restricted to essential categories such as pharmaceuticals, chemicals, food products and non-metallic minerals. Labour-intensive sectors such as textiles and wearing apparel remained weak owing to limited labour availability. 11 out of 23 sub-sectors within the manufacturing space recorded more than 30% YoY contraction, led by textiles (-54.3% YoY), wood & wood products (-50.5% YoY), transport equipment (-50.1% YoY), and motor vehicles, trailers and semi-trailers (-48% YoY). While mining production contracted by 20% YoY for yet another month (-20.5% YoY in May), reflecting weak domestic and global demand and labour issues, electricity production improved further, registering a drop of 10% YoY in June (-14.9% YoY in May).

  On the use-based side, contraction in capital goods and consumer non-durables remained quite significant for yet another month, down 36.9% YoY and 35.5% YoY respectively, reflecting a sustained weakness in investment and consumption demand despite easing of lockdown restrictions. This was followed by intermediate goods and infrastructure/constructions goods which recorded a drop of 25.1% YoY and 21.3% YoY respectively. Consumer non-durables production grew by a strong 14% YoY after contracting for the previous six months, largely led by a robust growth in pharmaceuticals and a meaningful improvement in food products.

- RBI to maintain status quo for now: Recovery going forward is expected to be slow and gradual amid a continued surge in COVID-19 cases and consequent localised lockdowns implemented by states. This is reflected in several high-frequency indicators such as Google mobility, auto sales, PMI, etc., which plateaued in July after picking up in June, signalling an incommensurate impact of exit policies in reviving sentiments. Inflationary pressures on the other hand are expected to remain high in the near-term on the back of persistence of supply chain disruptions, notwithstanding expectations of a good *kharif* harvest and weak aggregate demand, but should ease in the latter part of the fiscal, supported by a favourable base. This is likely to keep the RBI on hold in the next policy, even as we see room for another 25-50bps cut in the current easing cycle. This is likely to keep the RBI on hold in the next policy, even as we see room for another 25-50bps cut in the current easing cycle, contingent on a durable reduction in inflation trajectory. However, the conclusion of four-year term of existing external MPC members in September this year imparts uncertainty to future policy actions.

Persistence of inflationary pressures is likely to keep the RBI on hold in the next policy meeting.

We see room for another 25-50bps cut in this cycle contingent on a durable reduction in inflation trajectory.

Figure 1: Consumer price inflation in July 2020 (%YoY)

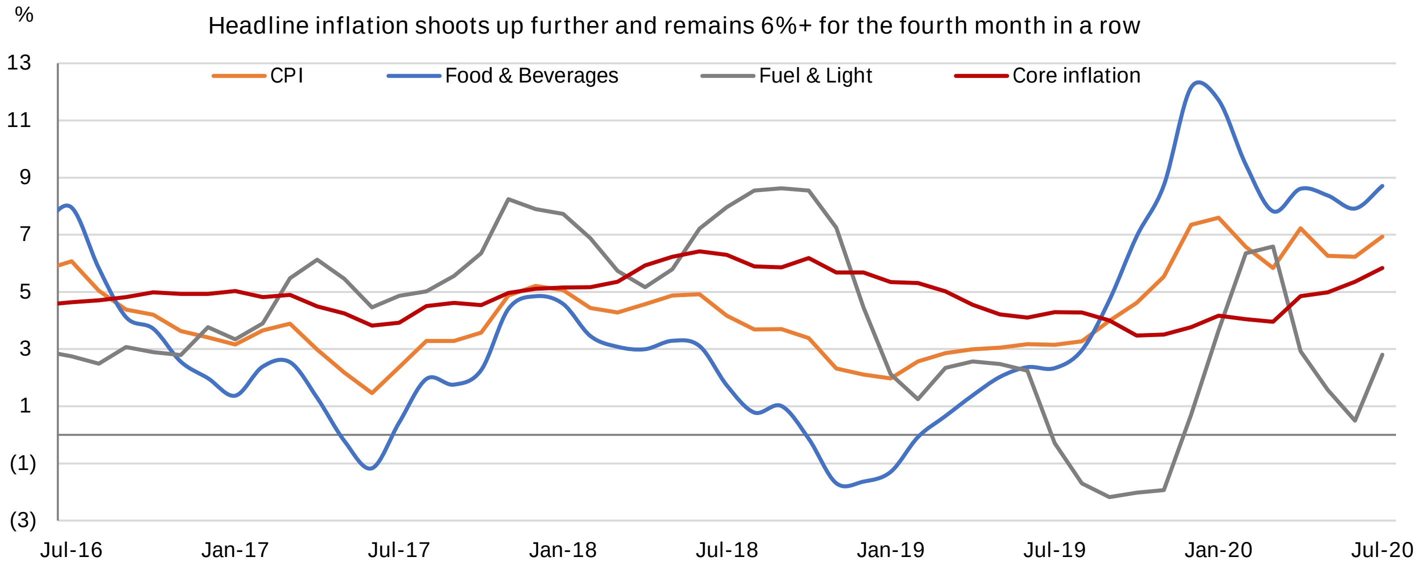
	Weight (%)	Jul-20	Jun-20	Jul-19	FY21TD	FY20TD
CPI		6.9	6.2	3.1	6.7	3.1
Food & Beverages	45.9	8.7	7.9	2.3	8.4	2.0
Pan, Tobacco & Intoxicants[2]	2.4	12.3	11.3	4.9	9.0	4.3
Clothing & Footwear[2]	6.5	2.9	2.7	1.4	3.1	1.7
Housing	10.1	3.3	3.5	4.9	3.6	4.8
Fuel & Light	6.8	2.8	0.5	(0.3)	1.9	1.7
Miscellaneous[2]	28.3	7.0	6.1	4.7	6.1	4.7
Core CPI inflation[1, 2]	47.3	5.8	5.4	4.3	5.3	4.3

Source: CSO, NSE. NA = Not Available.

Note: [1] Headline inflation excluding food & beverages and fuel & light.

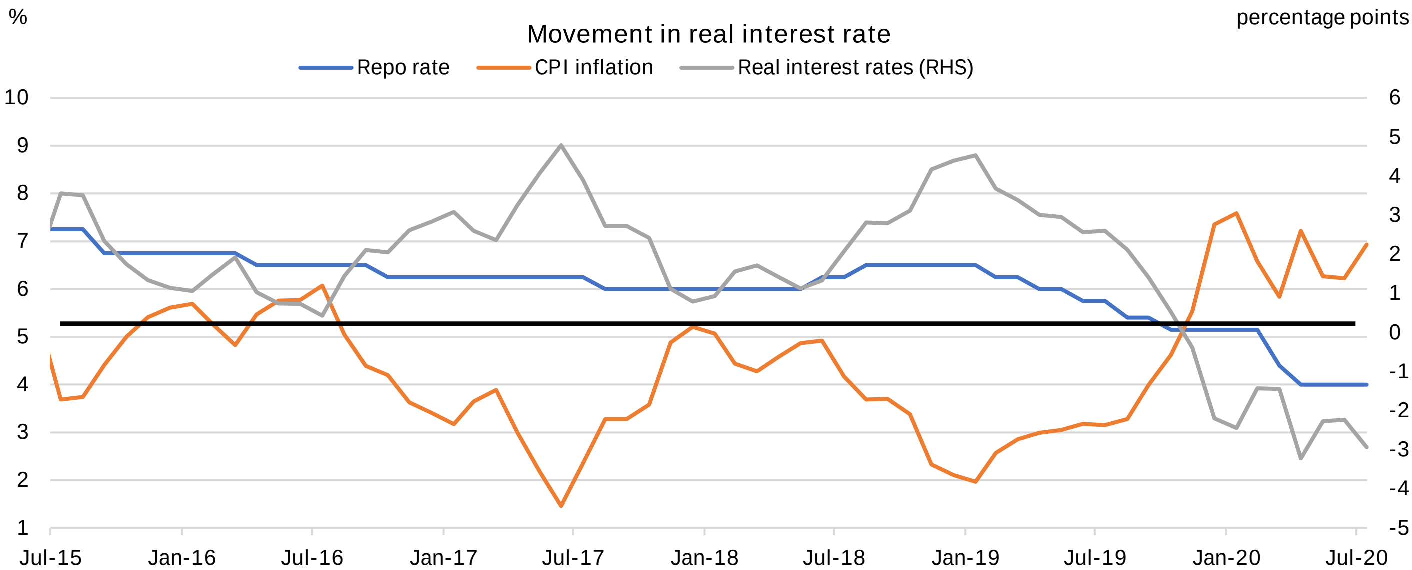
[2] Inflation data for these components for April and May 2020 are based on the imputed index calculated by MOSPI.

Figure 2: Headline CPI inflation trend



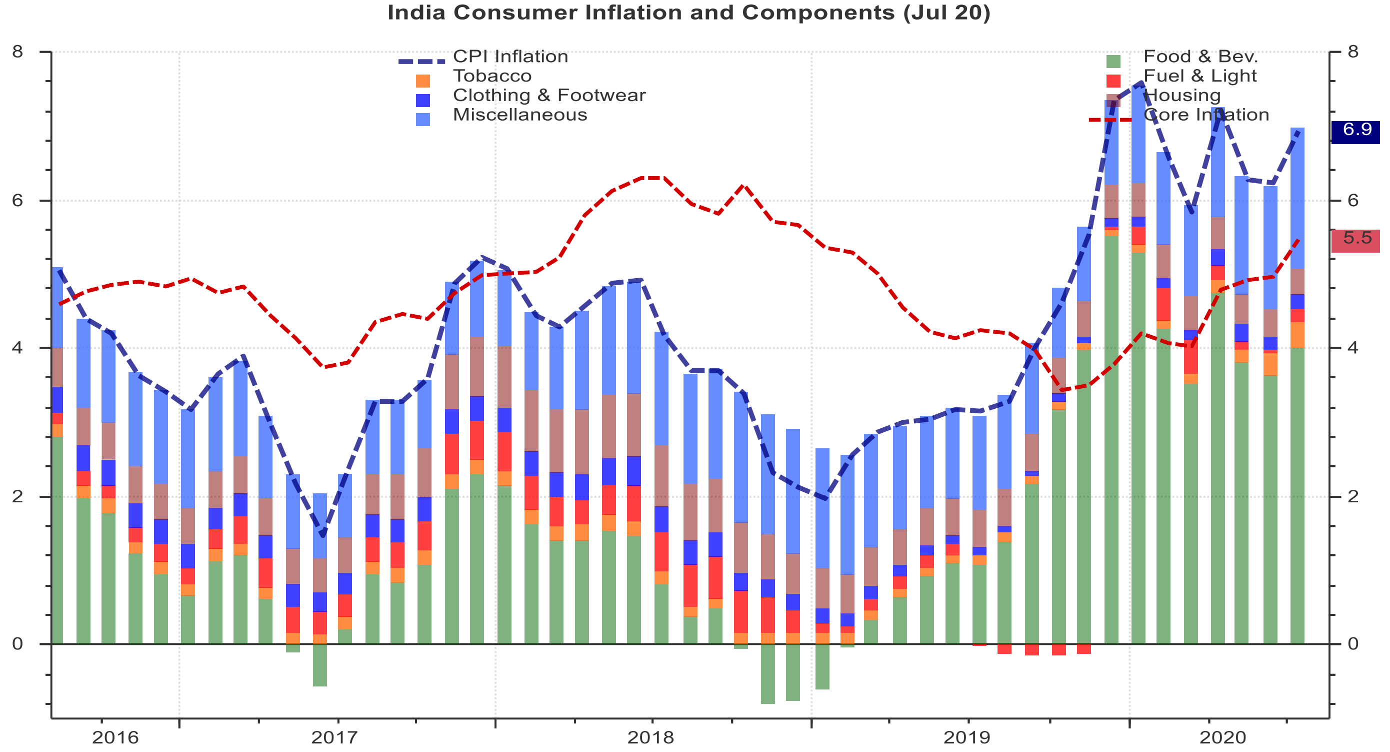
Source: CMIE Economic Outlook, NSE

Figure 3: Real interest rates have remained negative for quite some time now



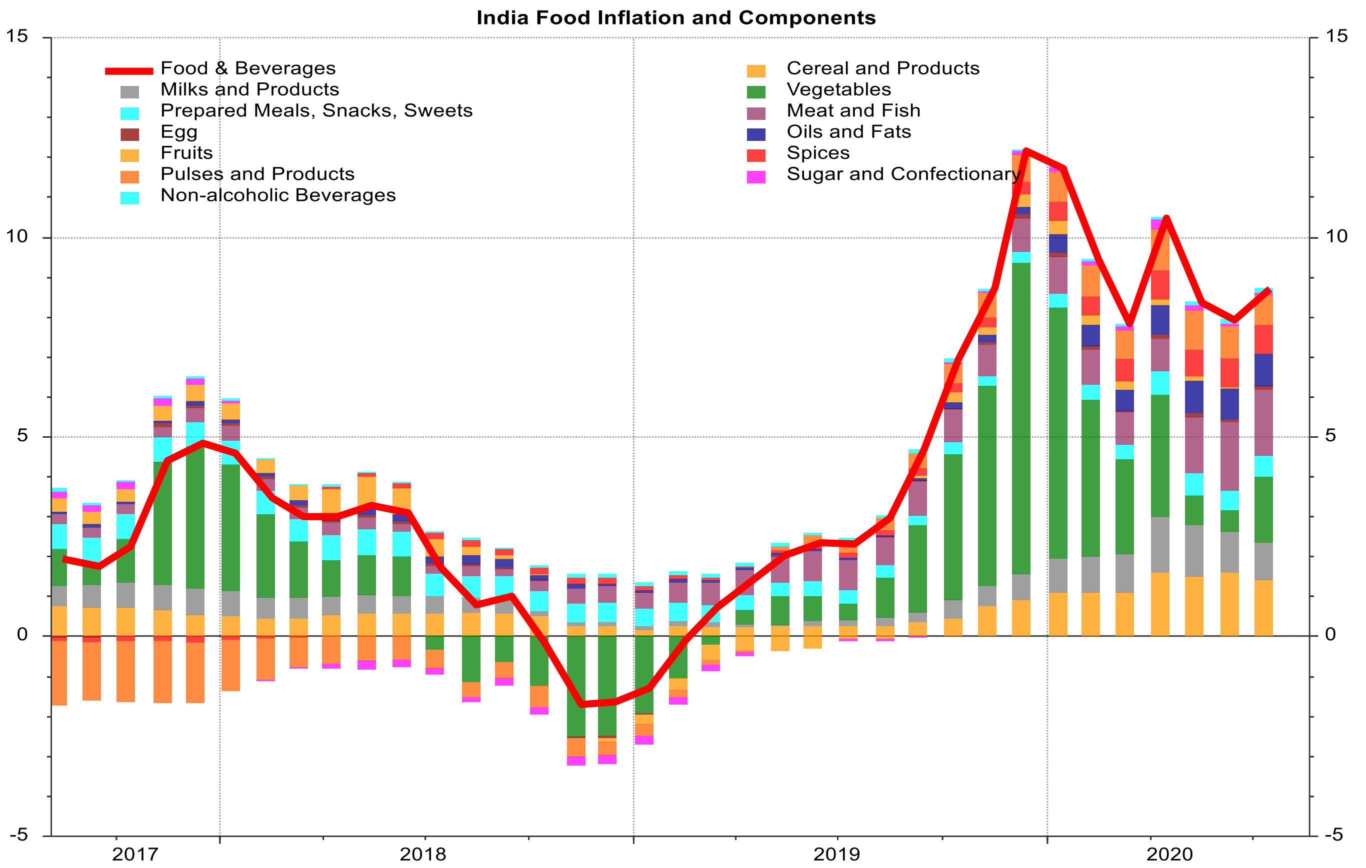
Source: CMIE Economic Outlook, NSE

Figure 4: Category-wise contribution to India consumer price inflation (CPI)



Source: Refinitiv Datastream, NSE.

Figure 5: Category-wise contribution to India Food and Beverages inflation (CPI)



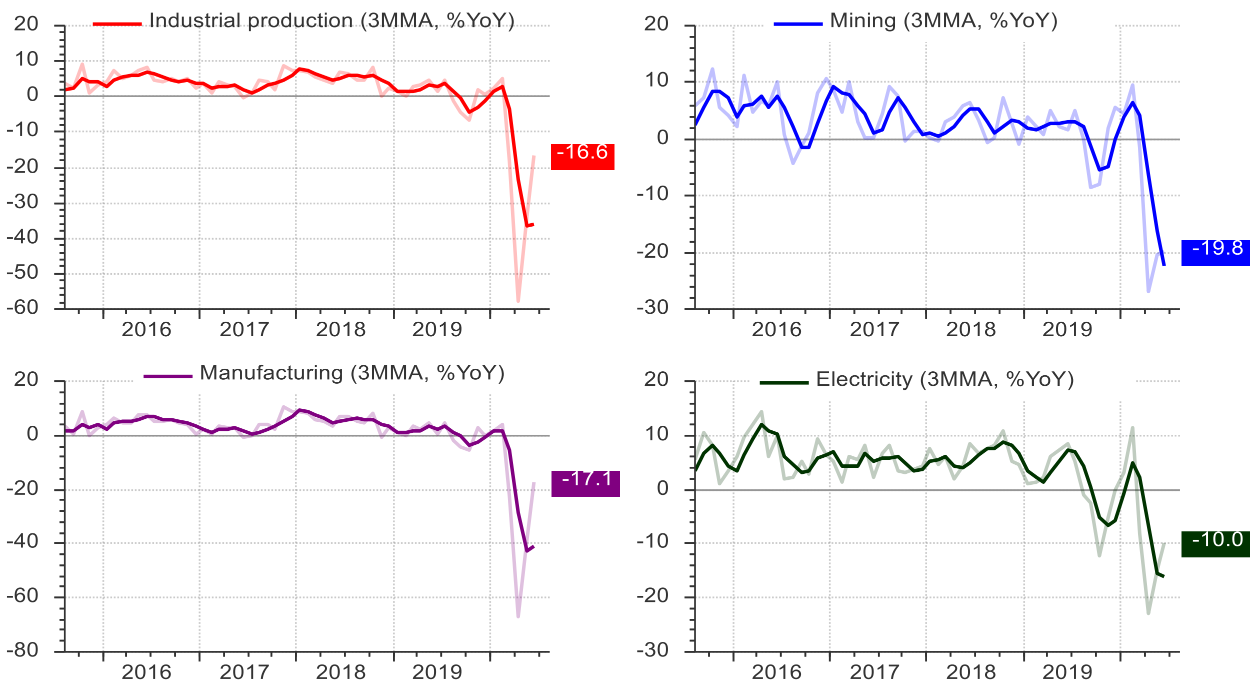
Source: Refinitiv Datastream, NSE.

Figure 6: India industrial production for June 2020 (%YoY)

		Weight (%)	Jun-20	May-20	Jun-19	FY21TD	FY20TD
	IIP		(16.7)	(33.9)	1.3	(35.9)	3.0
Sector-based indices	Mining	14.4	(19.8)	(20.5)	1.5	(22.4)	3.0
	Manufacturing	77.6	(17.1)	(38.4)	0.3	(40.7)	2.4
	Electricity	8.0	(10.0)	(14.9)	8.6	(15.8)	7.3
Use-based Goods	Primary Goods	34.0	(14.6)	(19.7)	0.6	(20.3)	2.6
	Capital Goods	8.2	(36.9)	(65.2)	(6.9)	(64.4)	(3.6)
	Intermediate Goods	17.2	(25.1)	(40.6)	12.1	(43.0)	9.2
	Infra/Construction Goods	12.3	(21.3)	(40.7)	(1.3)	(48.3)	0.4
	Consumer Goods	28.2	(6.9)	(36.0)	(0.8)	(37.6)	2.6
	Consumer Durables	12.8	(35.5)	(69.4)	(10.2)	(67.6)	(2.7)
	Consumer Non-durables	15.3	14.0	(11.1)	7.4	(15.3)	7.0

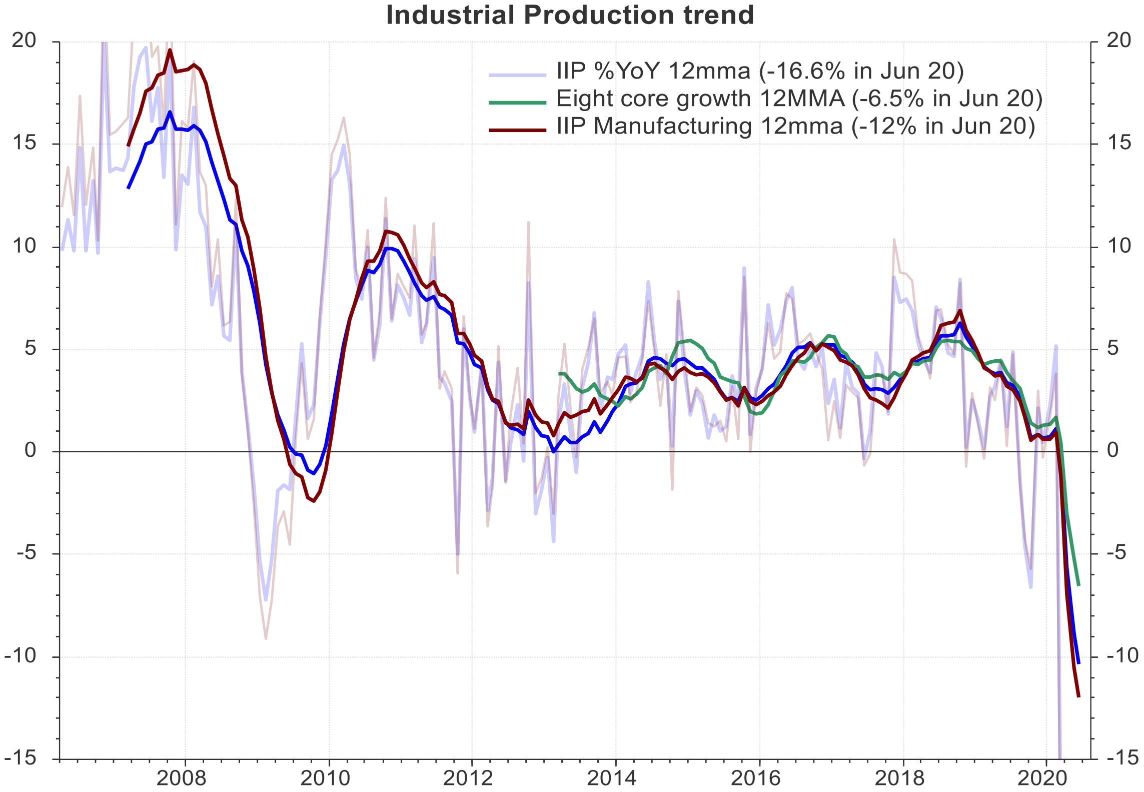
Source: CSO, NSE

Figure 7: India industrial production (3MMA)



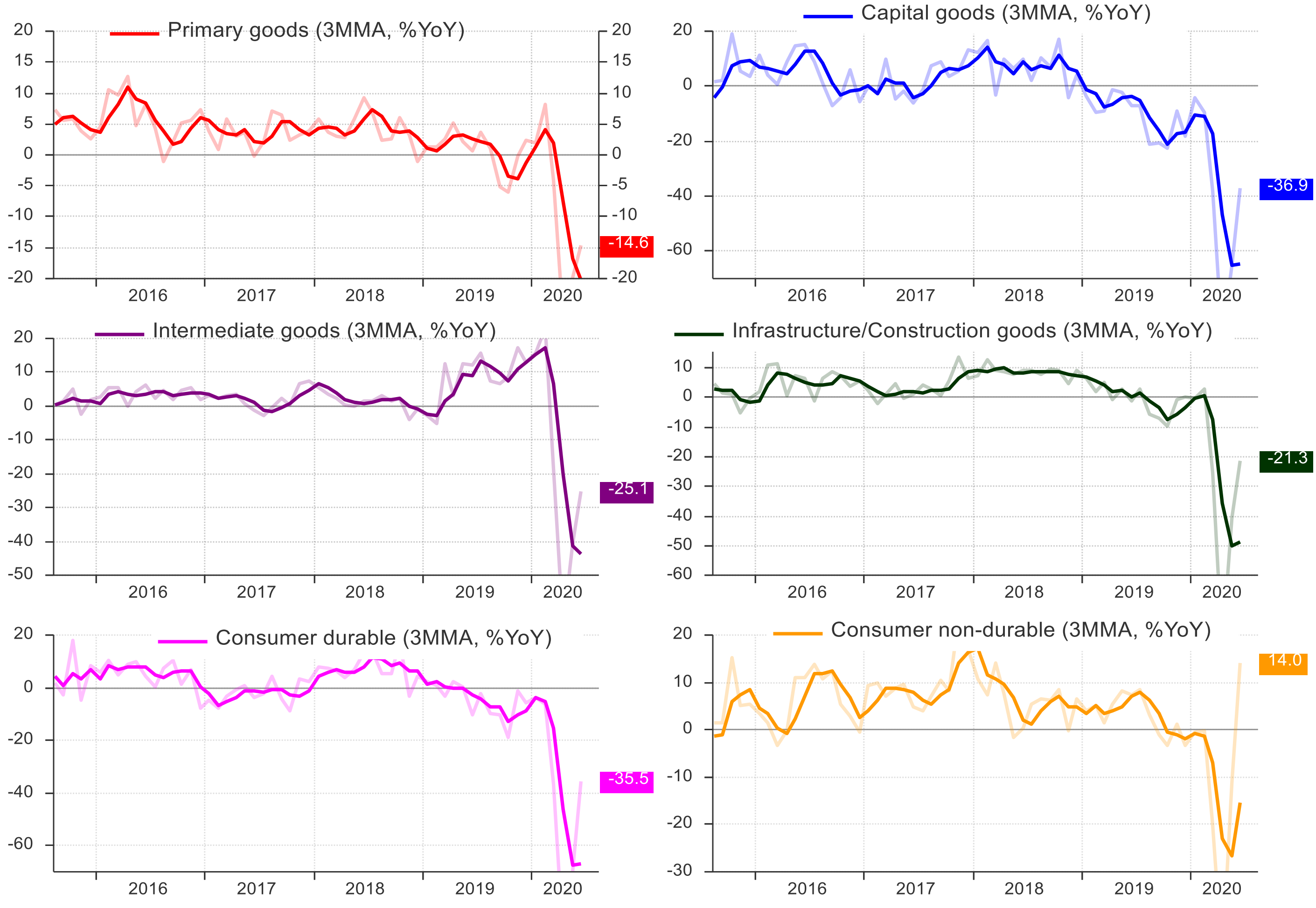
Source: Refinitiv Datastream, NSE

Figure 8: Long-term industrial production trend (12MMA)



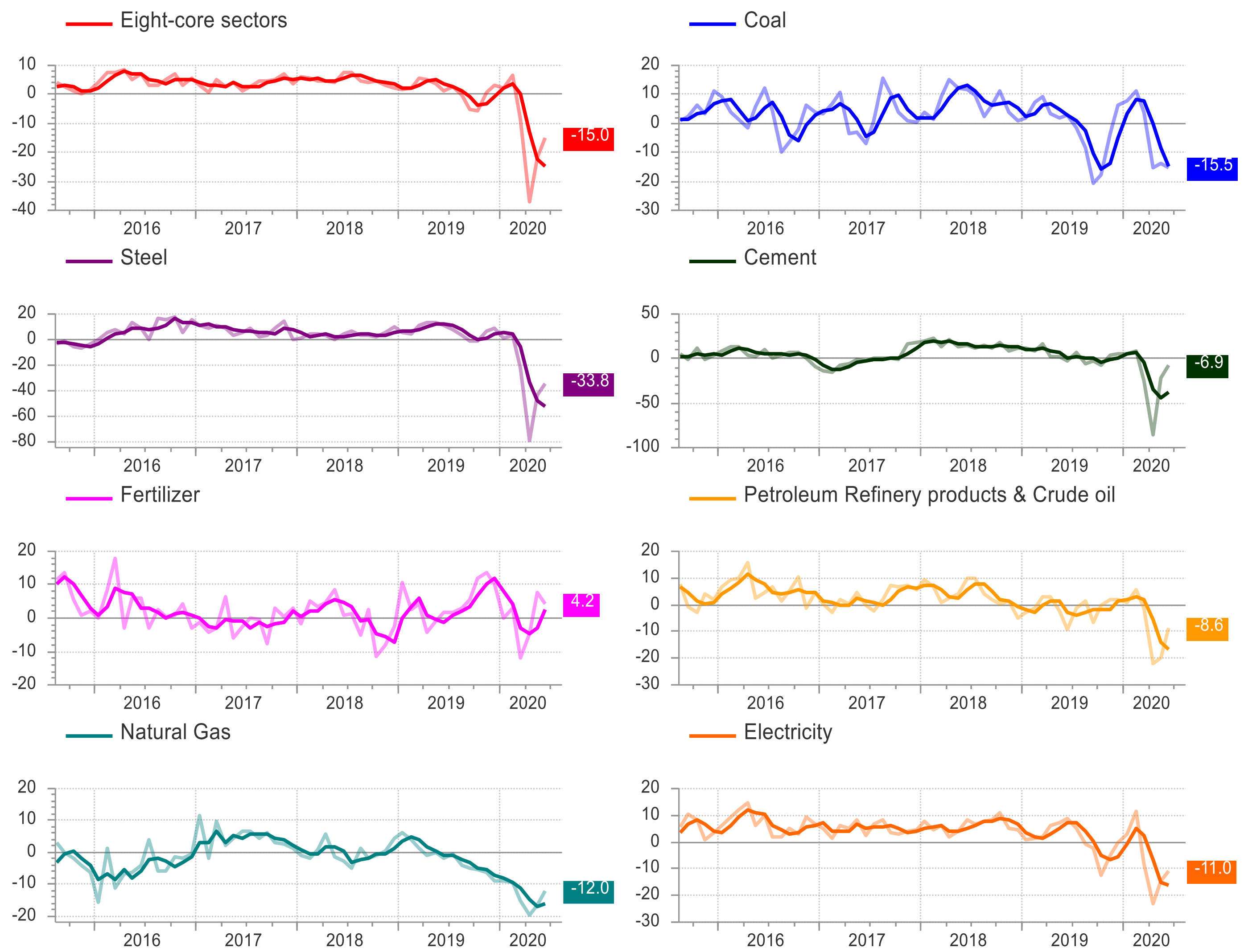
Source: Refinitiv Datastream, NSE

Figure 9: India industrial production use-based goods (3MMA)



Source: Refinitiv Datastream, NSE

Figure 10: India eight-core sector growth (3MMA)



Source: Refinitiv Datastream, NSE

Economic Policy & Research

Tirthankar Patnaik, PhD	tpatnaik@nse.co.in	+91-22-26598149
Prerna Singhvi, CFA	psinghvi@nse.co.in	+91-22-26598316
Ashiana Salian	asalian@nse.co.in	+91-22-26598163
Runu Bhakta, PhD	rbhakta@nse.co.in	+91-22-26598163